

Message Text

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S E C R E T SECTION 1 OF 2 TEHRAN 7479

NODIS/STADIS////////////////////////////////

EYES ONLY FOR UNDER SECRETARY ROBINSON FROM AMBASSADOR

E.O. 11652: GDS

TAGS: EFIN, ENRG, OECD

SUBJECT: DRAFT IEA POSITION PAPER ON INDEXATION OF OIL PRICES

REF: STATE 175861

1. WHILE I APPRECIATE THAT REFTEL MAY NOT REPRESENT OUR FINAL POSITION WITH RESPECT TO THE ISSUES OF INDEXATION OF OIL PRICES, I AM DEEPLY CONCERNED ABOUT THE DIRECTION IN WHICH IT SEEMS TO BE MOVING. IF I UNDERSTAND THE MATTER CORRECTLY, WE ARE PROPOSING THAT EXCEPT IN THE IMPROBABLE CIRCUMSTANCE THAT OPEC WOULD AGREE A PRIORI TO REDUCE OIL PRICES, WE WILL NOT EVEN TALK TO PRODUCERS ABOUT OIL PRICE INDEXATION OR SOME SIMILAR MECHANISM TO ESTABLISH OIL PRICES. IN MY JUDGMENT THIS LEADS TO CONFRONTATION AND NOT COOPERATION AND IS A RETREAT FROM WHAT THE SECRETARY SAID HERE PUBLICLY LAST NOVEMBER: I.E., THAT WE DID NOT RULE OUT THE POSSIBILITY OF SOME SUCH ARRANGEMENT. THE ARGUMENTS ADVANCED IN REFTEL TO SUPPORT SUCH A POLICY STRIKE ME AS MAINLY IDEOLOGICAL RATHER THAN PRAGMATIC AND UNLIKELY TO PERSUADE OPEC EITHER OF OUR GOOD INTENTIONS OR THE VIRTUE OF OUR POSITION. IF IT IS ACCEPTED AS REFTEL SEEMS TO THAT OPEC HAS THE MARKET POWER TO SET PRICES FOR THE FORESEEABLE FUTURE AND IS NOT LIKELY TO BARGAIN IT AWAY, THEN IT SEEMS TO ME WE HAVE ONLY TWO CHOICES. ONE IS TO DO DO AS REFTEL SUGGESTS AND NOT TALK TO OPEC ABOUT THE

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ISSUE IT MOST WANTS TO DISCUSS. I BELIEVE THIS IS BOTH

ECONOMICALLY AND POLITICALLY UNPRODUCTIVE AND WILL SIMPLY ENSURE THE CONTINUATION OF OPEC'S PRACTICE OF SETTING OIL PRICES UNILATERALLY ACCORDING TO ITS OWN RULES. IT ALSO SEEMS WELL CALCULATED TO ENGENDER FURTHER BITTERNESS AND DIVISIVENESS BETWEEN PRODUCERS AND CONSUMERS. THE OTHER COURSE IS TO SIT DOWN WITH PRODUCERS AND SERIOUSLY DISCUSS THE ISSUE IN THE FULL RECOGNITION THAT IN TERMS OF OIL PRICES WE MAY BE NO BETTER OFF IN THE END. IT SEEMS TO ME THAT AT A MINIMUM WE MAY AT LEAST POSTPONE, IF NOT AVOID, CONFRONTATION AND THE UNDESIRABLE SIDE EFFECTS IT MAY GENERATE. OUR AIM SHOULD BE A SHORT TERM AGREEMENT RENEWABLE IF BOTH SIDES SO DESIRE. IF MARKET CONDITIONS TURN TO OPEC'S DISADVANTAGE, THEN WE WOULD BE IN A POSITION TO DEMAND A CHANGE IN TERMS WITHIN AN AGREED UPON STRUCTURE OR SIMPLY NOT TO RENEW THE AGREEMENT.

2. AT PRESENT, AS I SEE IT, OPEC IS A SOLID REALITY AND WILL CONTINUE UNTIL US DEPENDENCE ON OPEC DIMINISHES SHARPLY. WHEN AND HOW MUCH THIS DEPENDENCE WILL DIMINISH OBVIOUSLY DEPENDS ON OUR OWN INTERNAL POLICIES AND PERFORMANCE, NOT ON OUR RELATIONS WITH OPEC. NEVERTHELESS, REASONABLY HARMONIOUS RELATIONS WITH OPEC SHOULD BE MAINTAINED TO BUY TIME FOR OUR INTERNAL POLICIES TO WORK WITH MINIMUM THREAT TO CONTINUED OIL SUPPLIES OR THE WHOLE RANGE OF OUR OTHER MUTUALLY BENEFICIAL TIES WITH OPEC.

3. IN OUR VIEW REFTEL HAS SOME GOOD POINTS BUT IT ALSO HAS WEAKNESSES AND RHETORIC THAT IS MEANINGLESS OR UNCONVINCING. OUR SPECIFIC COMMENTS FOLLOW:

A. OPEC IS LIKELY TO FIND IT STRANGE INDEED THAT THE US IS ARGUING(PARA C REFTEL) THAT "AN EFFORT TO SET PRICE ON THE BASIS OF ARBITRARY PARITY" WOULD "DISTORT THE MARKET'S ROLE IN THE ALLOCATION OF RESOURCES" IN LIGHT OF 70 YEARS OF US AGRICULTURAL POLICY IN THIS RESPECT.

B. THE ARGUMENT OF PARA D THAT WE MUST NOT "LEGITIMIZE" OPEC'S ABILITY TO SET THE PRICE OF OIL IS UNLIKELY TO HAVE MUCH MEANING OTHER THAN IN OUR OWN MINDS. OPEC OBVIOUSLY HAS THIS ABILITY AND HAS SUCCEEDED TO REMARKABLE DEGREE IN "LEGITIMIZING" ITS VIEWS IN EYES OF MOST OF WORLD INCLUDING SOME MSAS.

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C. THE ARGUMENT OF PARA E THAT INDEXATION WILL REQUIRE FURTHER STRUCTURAL ADJUSTMENT IN WORLD ECONOMY MEANS LITTLE, AS UNILATERAL OPEC PRICE INCREASES WILL ALSO REQUIRE SUCH ADJUSTMENT. IT SEEMS TO ME THE QUESTION IS WHETHER A UNILATERAL OR A NEGOTIATED SCHEME WOULD BE LIKELY TO INCREASE OIL PRICES FASTER, REQUIRING MORE RADICAL STRUCTURAL ADJUSTMENT.

D. IRANIAN OFFICIALS HAVE INDICATED SOME SENSITIVITY

TO THE ARGUMENT OF PARA F THAT INDEXATION WOULD "TEND TO INTENSIFY INFLATIONARY SPIRALS." NONETHELESS IT WOULD BE DIFFICULT IF NOT IMPOSSIBLE TO CONVINCE OPEC THAT OIL INCREASES HAVE CAUSED AS MUCH AS ONE-THIRD OF INFLATION IN OIL-IMPORTING NATIONS. TOO, OPEC AND WE HAVE SEEN ARGUMENTS BY SOME US ECONOMISTS THAT INCREASED PRICES OF OPEC MEMBERS' IMPORTS IMPACT MORE ON THEIR OWN ECONOMIES THAN DO INCREASES IN OIL PRICES ON OURS. THUS OPEC MEMBERS WILL BE PREPARED WITH COUNTER ARGUMENTS. STILL, IN GEGOTIATIONS ON INDEXING THIS WOULD BE A GOOD POINT TO MAKE, BUT IT WILL SEEM TO OPEC A WEAK EXCUSE FOR REFUSING TO TALK ABOUT INDEXING.

E. "PRECEDENT" ARGUMENT OF PARA G DOES NOT SEEM TO US OVERLY FRIGHTENING. IN BARGAINING, DC'S COULD SEEK OPEC AID IN PURSUING OTHER FORMULAS FOR OTHER GOODS, SUCH AS STOCKPILING/STABLIZATION TYPE AGREEMENTS PREVIOUSLY MENTIONED BY CBI GOVERNOR YEGANEH. IT SEEMS TO US THAT WHILE SUCH MECHANISMS AS THE FORMER INTERNATIONAL COFFEE AGREEMENT MIGHT BE CALLED "FAILURES" FROM AN ECONOMIC POINT OF VIEW, NEVERTHELESS THEY HAVE BEEN RELATIVELY HARMLESS. THE ATTEMPT TO NEGOTIATE SUCH STABILIZATION AGREEMENTS FOR A FEW POLITICALLY IMPORTANT COMMODITIES COULD BE WELL WORTH OUR WHILE. WE WONDER WHETHER USG HAS SERIOUSLY STUDIED THE QUESTION, BEFORE DISMISSING IT FOR REASONS OF OFFENDED IDEOLOGY. FOR THE REST, THERE SEEM TO BE AMPLE ARGUMENTS THAT BOTH POLITICALLY AND ECONOMICALLY OIL IS A UNIQUE CASE AMONG COMMODITIES, A WASTING RESOURCE FOR WHICH THERE IS NO ECONOMIC SHORT-TERM SUBSTITUTE. IT HAS BEEN CALLED A SUBSTANCE NOT USED FOR ITS OWN SAKE BUT NEEDED TO ENABLE US TO USE OTHER GOODS. IT IS, AT LEAST FOR SOME YEARS, AN IRREPLACEABLE "BASIC COMMODITY."

F. THE ARGUMENT OF PARA II THAT INDEXATION COULD CREATE ILLOGICAL AND UNFAIR PATTERNS OF REDISTRIBUTION OF WORLD INCOME IS ANOTHER THAT WE COULD USE IN CONTEXT OF
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NEGOTIATIONS ON INDEXATION BUT IT IS NOT ONE OPEC ACCEPTS FOR THE TIME BEING. INDEED, IT ARGUES THAT EITHER THROUGH AID TO LDCE OR PURCHASES AND INVESTMENTS IN DCS INCOME DISTRIBUTION HAS NOT BEEN UNDULY AFFECTED. IF WE HAVE PROOFS AND GOOD EXAMPLES, HOWEVER, OPEC MAY WELL BE SENSITIVE AND DEFENSIVE ON THIS ISSUE.

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FM AMEMBASSY TEHRAN

TO SECSTATE WASHDC 2803

S E C R E T SECTION 2 OF 2 TEHRAN 7479

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EYES ONLY FOR UNDER SECRETARY ROVINSON FROM AMBASSADOR

E.O. 11652: GDS

TAGS: EFIN, ENRG, OECD

SUBJECT: DRAFT IEA POSITION PAPER ON INDEXATION OF OIL PRICES

REF: STATE 175681

G. PARAGRAPH I'S ASSERTION THAT THERE IS "NO JUSTIFICATION FOR THE MAINTENANCE OF THE PRESENT TERMS OF TRADE OF OIL PRODUCERS" WHO HAVE MAINTAINED OIL PRICES BY UNILATERAL CARTEL ACTIONS IS NOT AN ARGUMENT. RATHER, IT IS AN EXPRESSION OF MORAL PRINCIPLE. THE OPEC CARTEL EXISTS; IT IS A MARKET REALITY. WE HAVE HELPED MAKE IT POSSIBLE BY ALLOWING OURSELVES TO BECOME DEPENDENT ON ITS OIL.

H. THE STATISTICAL ARGUMENT OF PARA J IS, OF COURSE, A SOUND ONE, AND WITH FULL SUPPORTING DATA, COULD BECOME AN IMPORTANT EDUCATIONAL TOOL IN INDEXATION NEGOTIATIONS. WE NOTE THAT AMOUZEGAR HAS PREVIOUSLY SAID THAT THE BASE PERIOD FOR INDEX SHOULD BE EITHER THE FIRST QUARTER OF 1974 OR THE YEAR 1947. A CAREFUL EXPOSITION OF PRICE BEHAVIOR OF NUMEROUS GOODS SINCE 1947 COULD BE MOST USEFUL IN DEBATING INDEXATION.

I. ONLY ANSWER TO PARAS K AND L (WHICH COMPLAIN OF "PRACTICAL PROBLE" OF INADEQUATE STATISTICS AND INDEXES) IS THAT OF COURSE NO PERFECTLY LOGICAL AND ECONOMICALLY REALISTIC INDEX EXISTS OR IS EVER LIKELY TO EXIST. PERHAPS WE SHOULD STUDY MORE CAREFULLY THE HISTORY OF OIL COMPANY

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NEGOTIATIONS WITH OPEC FROM 1970 THROUGH 1973, IN PARTICULAR THE DEVELOPMENT OF THE SHORT-LIVED GENEVA I AND II FORMULAS, THE BETTER TO UNDERSTAND THE WAY OPEC THINKS AND NEGOTIATES

ON SUCH ISSUES. THE POINT IS THAT THE GENEVA FORMULAS HAD VIRTUALLY NO LOGIC, NOT EVEN MATHEMATICAL. EACH OF THEM WAS SIMPLY A RULE THAT MADE OIL PRICES MOVE IN THE PROPER DIRECTION AFTER FLUCTUATIONS IN CURRENCY VALUES, WITHOUT GIVING OPEC FULL COMPENSATION FOR THOSE CURRENCY FLUCTUATIONS. THE POINT ABOUT INDEXATION IS THAT IT SUPPLY PROVIDES A STRUCTURE OR RULE FOR DETERMINING OIL PRICES. AS WE HAVE OBSERVED PREVIOUSLY, THE THREE ITEMS THAT MAKE UP AN INDEX FORMULA, NAMELY, THE BASE PERIOD, A MARKET BASKET, AND A FORMULA RELATING THE VALUE OF A MARKET BASKET TO THE PRICE OF OIL, ARE ALL ITEMS THAT WOULD HAVE TO BE NEGOTIATED. UNTIL THEY HAVE BEEN NEGOTIATED, IT IS USELESS TO ATTEMPT TO PREDICT THE EFFECTS OF INDEXING. AS TO THE END OF PARA L, WE WONDER HOW RELEVANT IT IS WHETHER INDEXING IS ACCEPTABLE TO CONSUMERS OR NOT. AGAIN, IF WE WILL NOT PARTICIPATE IN INVENTING A FORMULA, OPEC WILL MAKE UP ITS OWN.

J. PARAGRAPH M(WHICH CLAIMS CONSUMERS WILL BECOME GUARANTORS OF OPEC PRICES, THUS LOSING THE CHANCE TO EXPLOIT OPEC INTERNAL DIFFERENCES AND FRICTIONS) IS A QUESTIONABLE STATEMENT AS APPLIED TO OIL MARKETS. AN INDEXING ARRANGEMENT MUST TIE THE PRICE OF A BENCHMARK CRUDE TO THAT OF A MARKET BASKET. DIFFERENCES IN LOCATION AND QUALITY OF VARIOUS CRUDES AND IN THE DEMANDS OF THE VARIOUS MAJOR MARKETS WILL REMAIN A POTENTIAL SOURCE OF DIFFICULTY TO OPEC, THOUGH SUCH DIFFICULTIES WILL OF COURSE NOT BECOME GREAT UNTIL WE SUCCEED IN BEGINNING TO SOLVE OUR DOMESTIC ENERGY MARKET PROBLEMS.

K. HOPEFULLY THE IDEA OF PARA N, THAT AN INDEXATION AGREEMENT INTENDED TO BUY US TIME TO SOLVE OUR ENERGY PROBLEMS WHERE THEY MUST BE SOLVED-AT HOME-WOULD LULL US INTO A SENSE OF FALSE SECURITY, WILL PROVE MISTAKEN. ADMITTEDLY OUR RECORD IN THIS SENSE IS NOT ENCOURAGING.

4. AS SUGGESTED IN THE FOREGOING, MANY OF THE DETAILED ARGUMENTS IN REFTEL WOULD BE USEFUL, IF USED IN NEGOTIATIONS ON INDEXING IN AN ATTEMPT TO GET THE BEST POSSIBLE DEAL. IF THEY ARE USED SIMPLY TO ARGUE AGAINST
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THE IDEA OF TALKING ABOUT INDEXING, OPEC IS UNLIKELY TO BELIEVE WE WANT TO PRACTICE "COOPERATION, NOT CONFRONTATION." WE WOULD URGE THAT THE USG AND IEA CONSIDER NEGOTIATING WITH OPEC A NEUTRALLY-TITLED AGENDA ITEM--PERHAPS SOMETHING SUCH AS "DISCUSSIONS ON DEVELOPMENT OF AN AGREEMENT ON AN OIL-PRICING MECHANISM" THAT WOULD PERMIT ALL PARTIES CONCERNED TO HASH OVER THE ISSUES DISCUSSED ABOVE AND IN REFTEL, AND POSSIBLE TO NEGOTIATE AN INDEX, IF A SUFFICIENTLY FAVORABLE ONE CAN BE OBTAINED. SUCH AN INDEX NEED NOT POSSESS PERFECT ECONOMIC LOGIC. IT

NEED ONLY BE A ROUGH, AGREED RULE FOR A SHORT TERM, AS WERE THE INFLATION ESCALATORS OF THE 1971 TEHRN AGREEMENT AND THE GENEVA I AND II FORMULAS. WE RECOGNIZE THESE WERE NOT RESPECTED BY OPEC FOR ANY LENGTH OF TIME AND THERE IS OF COURSE NO GUARANTEE THAT OPEC WILL RESPECT ANY NEW AGREEMENT. IF CIRCUMSTANCES CHANGE OPEC COULD BREAK AN INDEXING AGREEMENT BY ACTING IN WAY IT WOULD HAVE ACTED IF THERE WERE NO SUCH AGREEMENT. WE DOUBT CONSUMERS WOULD BE WORSE OFF. POLITICALLY, HOWEVER, WE BELIEVE CONSUMERS WOULD BE IN A STRONG POSITION IN SUCH CIRCUMSTANCE. WE NOTE THAT AGREEMENTS OPEC HAS VIOLATED IN PAST WERE WITH OIL COMPANIES. OPEC MIGHT FIND AN INTER-GOVERNMENTAL AGREEMENT HARDER TO BREAK. FINALLY, WE THINK WORRY THAT OIL INDEXING MAY BECOME AN UNACCEPTABLE PRECEDENT IS MISPLACED: OPEC MAY WELL JOIN US IN ARGUING THAT OIL IS UNIQUE, THOUGH THEY WILL WANT DC'S TO PARTICIPATE IN STABILIZATION AGREEMENTS ON SOME OTHER POLITICALLY IMPORTANT COMMODITIES.

5. THE FOREGOING IS INTENDED TO BE CONSTRUCTIVE AND I HOPE IS TAKEN AS SUCH. I DO NOT MINIMIZE THE DIFFICULTY THIS ISSUE POSES FOR US OR QUESTION THE SINCERITY OF OTHERS THAT HOLD A DIFFERENT POINT OF VIEW. I FEEL I WOULD BE DERELICT IN MY DUTY, HOWEVER, IF I FAILED TO RECORD MY OWN VIEW OF HOW OUR NATIONAL INTERESTS MAY BE BEST SERVED IN THE CIRCUMSTANCES.

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